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Landmark Ruling Can Significantly Increase Research and Development Tax Credit

By

Mark Lauber and Saqib Dhanani

If your company conducts intercompany transactions, this landmark decision may help increase your research and development tax credit amount significantly. This article reviews the rulings and its significance in the R&D Tax Credit calculations.

On June 25, 2010 the District Court for the Southern District of Ohio issued a monumental decision in favor of Procter & Gamble and all U.S. corporate taxpayers (*Procter & Gamble Co. and Subsidiaries v. United States*, No. 1:08-cv-00608-TSB). The Court found that intercompany sales should not be included as a component of Gross Receipts, thereby affirming and preserving the Tax Credit's substantial benefits and incentives for innovation to the U.S. taxpayer.

At issue is whether "a taxpayer must include the results of its intercompany transactions within its 'Gross Receipts' for the purposes of determining the amount of its research credit under 26 U.S.C. § 41." The question is a fundamental one because higher gross receipts have the effect of increasing a corporation's Base Amount for credit computation purposes and therefore reduces the amount of research credit that a company may be entitled to. The amounts are often staggering and in Procter & Gamble's case, upwards of \$20 million.

Controlled groups of corporations are treated as a single taxpayer, but the provisions of § 41 regarding intercompany transfers to domestic and foreign subsidiaries have had a contentious existence and have often been supplemented by inconsistent IRS guidance. Specifically, the IRS issued conflicting instructions between Chief Counsel Advice (CCA) 200233011 and CCA 200620023 in which the former directed companies to *exclude* intercompany sales between domestic and foreign corporations and the latter did not.

Procter & Gamble stated that intercompany transactions are properly disregarded under 26 U.S.C. § 41(f) of the Internal Revenue Code and Treasury Regulation 26 C.F.R. § 1.41-6T(i) and that "the IRS' subsequent decision to reverse its prior position contradicts the statute and the IRS' own regulations, and is contrary to the intent of Congress in enacting the research credit provisions." Defendant IRS has alleged that intercompany transfers to foreign subsidiaries should be included in the Gross Receipts calculations and relied on 26 U.S.C. § 41(c)(6) as it "specifically addresses what is to be included in Gross Receipts, and that this specific provision, rather than § 41(f), controls."

The Court analyzed the plain language of the Statute, prior case law, Treasury Regulations and the legislative history surrounding the Statute and determined that "the rationale behind excluding intercompany transactions in general is straightforward: intercompany sales do not represent sales to the company's customers, but rather, they serve only administrative or legal purposes internal to the business itself. Including intercompany transfers within the Gross Receipts calculation for the research credit could result in double, triple, or other such multiple counting of transfers."



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The decision represents a milestone for corporate tax guidance and methodologies and is a victory for corporations involved in the increasingly complex and global marketplace as it preserves the substantial tax incentives available to companies engaging in research and development activities. If your company is engaged in intercompany transactions, now is the time to review your R&D Tax Credit calculations to take advantage of this watershed ruling.

About the Authors:

The authors are Saqib Dhanani, J.D., and Mark Lauber, VP of Marketing, M.S. Industrial Engineering, both of Paradigm Partners. Paradigm Partners is a national tax consulting firm specializing in niche tax services such as the R&D Tax Credit, the IC-DISC (U.S. Exporters' Tax Incentive), WOTC (Federal and State Hiring Tax Incentives), Section 179 and Cost Segregation. Mark's email is MLauber@ParadigmLP.com and his phone number is (281) 558-7100 X-105. Our website is www.ParadigmLP.com.